

## **Resource: Selecting and Managing Securities Broker-Dealers for Investing**

**This GFOA Resource corresponds to:**

### **GFOA's Best Practices: Procurement of Financial Services, Development of an Investment Policy**

*GFOA recommends that governments review their financial services every five years and use a competitive process for the procurement of financial services. A competitive procurement process provides an opportunity for the government to obtain market competitive rates and negotiate preferable terms and conditions and/or service enhancements in financial service contracts. It also gives the government an opportunity to take advantage of technology enhancements, service changes, or evolution in the market. Identifying a regular schedule for soliciting competitive bids for financial service providers also helps reduce the risk of a government becoming too reliant on one vendor.*

### **Background**

Governments who self-direct their investment portfolio will interact directly with securities broker-dealer professionals. This resource discusses the procurement of securities broker-dealers and how governments should manage the ongoing relationship with these professionals. Governments should also be aware of federal, state and local laws that relate to the use of and requirements for securities dealers doing business in the public sector. GFOA's Best Practice: Investment Policy recommends that each government establish processes related to the financial institutions, depositories and broker-dealers that will provide the primary services necessary for executing the investment program. Remember, the governmental entity has the fiduciary duty to make sure they are only make purchases that fit within the investment policy.

Generally, access to the securities markets is made through securities broker-dealers who are registered broker-dealers and through financial institutions (banks) with broker-dealer subsidiaries. Please be reminded that broker-dealers do not have a fiduciary duty to their clients, but must abide by regulations developed by FINRA for broker-dealers, including "Know Your Customer" and suitability standards.<sup>i</sup>

### **EVALUATION CONSIDERATIONS FOR SELECTING BROKER-DEALERS**

With every competitive procurement process, governments should define the scope of the procurement opportunity, identify specific evaluation criteria, and prepare a strategy to evaluate responses.

Evaluation criteria specific to the evaluation of securities broker-dealers should include the following project scope and evaluation considerations:

#### **Project Scope**

When soliciting proposals for securities broker-dealers, governments should carefully define the scope of the project desired:

- Select the number of broker-dealers that are suitable to the government, allowing for appropriate competition/service on all transactions.
- Define performance and contact expectations.
- Ensure that the entity's process follows all regulations and supports the governments adopted investment policy.

- Require that broker-dealers certify to the entity that they understand your investment policy and your state and local regulations.
- Require that all broker-dealer transactions be delivered on a delivery vs. payment (DVP) basis.
- Request what services the broker-dealer must provide to the entity, such as weekly economic updates, rate sheets, and periodic portfolio analytics.

Evaluation Considerations:

- **Services Provided:** Review the services that will be provided by the broker-dealer to ensure that they meet the government's criteria, strategy and purpose. Services should include an account that allows for a DVP set up, their ability and willingness to work with the block sizes and frequency of your entity's trades, weekly rate sheets, and may include economic updates and periodic portfolio analytics. Also verify that they understand the fixed income market and trade daily within it.
- **Choosing Broker-Dealers for Specific Investment Needs:** It is important to note that different broker-dealer firms may have different and unique strengths that may provide exceptional value within a specific category of investments. Regardless, the governmental entity must fully understand the security that it is purchasing, that it dovetails with the entity's investment policy, and staff is aware of the risks associated with the transaction.
- **Understanding Entity's Investment Policy and Familiarity with State Laws:** Require that broker-dealers provide written acknowledgement or certification of their review and understanding of the government entity's investment policy as well as state and local regulations to assure compliance with its objectives, portfolio risk constraints, and investment trading requirements. Governments should also determine that the broker is actively involved in the market sectors utilized by the government entity.
- **Past Performance:** If a broker-dealer has previously worked with the entity, they should evaluate their performance related to transactions and quality of service.
- **Work for Similarly Sized Governments:** The government should ask for a list of current clients that are similar in size to their government to determine if the broker-dealer knows how best to address the issues related to your entity's needs.
- **Review of Regulatory Registrations and Violations:** All potential broker-dealers should be assessed on their regulatory registrations and violations. For any violations, a decision needs to be made if they regarding whether or not the violations were material or administrative in nature. Governments should check broker-dealer status on FINRA's Broker Check site. This should be reviewed at least annually.
- **Capital Requirements:** Securities broker-dealers may be initially evaluated/selected based on meeting some minimal net capital requirements and post selection on the relative competitiveness of bids/offers.
- **Conflicts of Interest:** Governments should do their due diligence to ensure they are not conflicts of interest with any local officials or senior management employees regarding the use of broker-dealers. Broker-dealers should disclose any conflicts of interest.
- Develop a set of questions for interviewing each broker-dealer to evaluate them that are specific to the execution of the government's investment program.

## **MANAGING THE RELATIONSHIP WITH SECURITIES DEALERS**

Once a government has selected the securities dealers it will be working with, it is essential to develop a communication plan that should cover the following:

- Methods of communications such as email and phone and when they may be appropriate
- Expectations for discussing the market conditions and the effect on your entity's portfolio.
- Reviewing your entity's investment policy and portfolio strategy, at least annually.
- Portfolio Analytics.
- Verify that all trades are settled on a DVP basis.
- Broker-Dealers should be evaluated continuously throughout the year.

**Governments should have policies and procedures in place related to investing and working with securities dealers. Key areas of discussion in these documents should include:**

1. All securities will be held for safekeeping in a third-party bank separate from the broker/dealer that is transacting business.
2. For records retention and for audit purposes, the following information about the broker/dealer should be gathered, maintained and annually confirmed:
  - all contact information for the primary contact, backup and operations staff;
  - a broker's manager and supervisor;
  - annual acknowledgement that the firm and key professionals have read your government's investment policies;
  - registration with FINRA and any material citations; governments should carefully review any citations against a firm or professional to determine if they are material
  - governments should be aware of any laws or regulations that impact broker-dealers and their government clients
3. Establish a competitive procedure for obtaining reasonable market rates on investment transactions:
  - Require security sales and purchases be made through a competitive bid process with at least three bids among all approved broker/dealers. If three bids can not be obtained, compare the bids received to recently quoted market prices.
  - Governments should have a process to determine if the purchase yield of new issue securities is fair and competitive.
4. Governments should be aware of current and emerging technologies and platforms that may better facilitate trades and improve transparency.
5. Governments should identify authorized personnel who can interact with securities dealers and sign off on documents and trades. This information should be reviewed often and updated as needed.
6. Ensure that the relationship with broker/dealers continues to meet the entity's investment criteria, strategy and purpose of the government, at least annually. If it is determined that the needs are not met, the government should consider discontinuing the relationship with those broker/dealers.

For GFOA's Canadian members, the IIROC serves the function of FINRA where noted and should be consulted therein.
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<sup>i</sup> standards